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THE CANADA-U.S. FREE TRADE AGREEMENT AND FOREIGN DIRECT INVESTMENT[1]

by

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Introduction

Many Canadians have an ambivalent attitude toward foreign-owned firms in Canada. They believe there are economic or political problems associated with them, and consequently favor some degree of government control. They are also aware of the economic benefits that such firms can bring; hence, they are reluctant to see them leave and may favor efforts to attract them.

What will Canada gain and give up with regard to foreign direct investment by the terms of the proposed Free Trade Agreement with the United States?[2] This question presents at least two major issues that are the subject of this Trade Monitor. The first is the way in which the proposed Agreement affects the ability of Canadian governments to influence business decisions on the flows of direct investment to Canada. The second issue is the effects of freer trade on the behavior of existing foreign-owned firms.

Both of these issues were the subject of extended controversy before the Agreement was published, and the controversy continues. Supporters and critics of the Agreement have made a wide variety of assertions and counterassertions. This is not surprising, since any examination of these issues is necessarily conjectural, at least in part. It need not be reduced to a guessing game, however, since substantial evidence does exist to help us analyze the effects of the Agreement. Part of the evidence is in the form of studies, both retrospective and prospective, of the investment behavior of firms faced with declining barriers to trade. Another part is what the Agreement has to say about government powers, and about the options available when some powers are curtailed. It is far easier, of course, to assert conclusions than to examine them. The debate on free trade sometimes resembles the closing scene in The Sorcerer's Apprentice, where the destruction of one broom instantly leads to the creation of two others. The inten-

tion of this Trade Monitor is to clarify the issues surrounding an important and complex aspect of the Agreement.

Government Policies and the Agreement

How will the Agreement affect what Canada and the United States are now doing to regulate foreign direct investment? How will it affect their power to undertake policy on such investment in the future?

Major Investment Provisions

Briefly, the Agreement's provisions on foreign direct investment are as follows:

1. Each country will provide "national treatment" to the other's investors, with certain exceptions. National treatment means that foreign-controlled firms are treated no less favorably than domestically controlled firms in similar situations. This applies to measures affecting the establishment, acquisition, sale, and operation of business enterprises. More particularly, the two countries agree that (a) they will not require that minimum levels of equity be held by nationals, (b) they will not require forced divestiture, (c) there will be fair standards for expropriation and compensation, and (d) they will not impose export, local-content, local-sourcing, or import-substitution requirements on each other's investors. Some exceptions are provided for Crown corporations -- for example, limitations can be placed on foreign ownership when such corporations are sold to private owners.

2. Each country can retain all existing laws, regulations, and published policies and practices not in conformity with the obligations noted above. Both countries, in fact, have a long list of such measures. Canada, for example, limits or prohibits foreign ownership in a variety of media, some types of transport, and uranium production. In the United States, there are limitations on foreign ownership of broadcasting, land, and various aspects of transportation, among other sectors.[4]

3. Canada agrees to raise progressively the current $5 million exemption level for review of direct U.S. acquisitions of Canadian-owned firms to $150 million (in gross assets, measured in constant dollars). Review of indirect acquisitions -- that is, those where the parent firm's ownership changes -- will be phased out.

4. The "cultural industries" are excluded from the investment chapter, with regard to both national treatment and the new limits to the review process. Each country, however, retains the right to trade-remedy actions in such industries. Canada agrees to purchase such businesses at a fair value where divestiture is required.

5. Canada agrees to accord U.S. firms national treatment with respect to ownership of Canadian financial institutions. In particular, this will end the current 25 percent limit on foreign ownership of Canadian bank assets -- although not the 10 percent limit for any one owner, domestic or foreign -- and also end the limit on the total domestic assets of foreign bank subsidiaries. The United States agrees to give Canadian financial institutions the same treatment as U.S. institutions if it ends the Glass-Steagall Act, which limits bank ownership of securities firms.

6. The Agreement covers a number of other services industries by applying principles similar to those in the investment chapter -- namely, provision for national treatment, right of establishment, right of commercial presence, transparency of policies, and provisions for dispute settlement.

The Effect on Present Policies

How, then, will the Agreement change what the two countries now do with res-

pect to investment? As noted above, each country now closes some sectors, in whole or in part, to foreign ownership, and each has various forms of fiscal discrimination as well. Outside of financial services, the Agreement changes little with regard to such measures, since existing laws, regulations, and published policies and practices are exempted from the national treatment provisions. That includes Canadian ownership objectives in petroleum, gas, and uranium, and the entire cultural sector as defined in the Agreement. These sectors will continue to be subject to present regulations on acquisitions and divestment -- although, as noted earlier, a new rule on compensation for divestitures is to be introduced.

Canadian Policy Changes

Since the United States has no comparable foreign investment review process, it is clearly Canada that made the concessions on this issue. Except for acquisitions in the middle-size range of firms, however, Canada has given up rather little in terms of actual practice. This applies not only to what Investment Canada has been doing since its inception but also to the way the Foreign Investment Review Agency (FIRA) operated in its last two years or so.

Apart from the energy sector and cultural industries, FIRA's regulations and operations were significantly eased after 1982. In that year, the ceiling for small business investments was raised from 100 employees and $2 million in gross assets or planned investments to 200 employees and $5 million. New business proposals or direct acquisitions below these figures involved fewer data requirements and faster approval processes. In the previous decade, over 85 percent of all reviewable applications involved assets below $5 million. Other measures were also taken after 1982 to clarify and facilitate the review process.

The Investment Canada Act, which came into force on June 30, 1985, was designed to encourage and facilitate investment in Canada, in contrast to the widespread perception regarding the operations of FIRA before 1982. Under Investment Canada, only notification, rather than review, has been required for all new businesses (regardless of size), for all direct acquisitions with assets under $5 million and for most indirect acquisitions with assets under $50 million. However, new businesses and smaller acquisitions in designated sectors such as the cultural industries have remained subject to review. Up to the end of 1987, Investment Canada had not rejected any of the acquisitions it reviewed.

The change to Investment Canada evidently exempted from review the great majority of the number of cases reviewable by FIRA. Under the Agreement, review of indirect acquisitions will be phased out entirely. This has been used to some effect in the petroleum and cultural industries; in these two sectors, the existing provisions have been retained. As for direct acquisitions, about two-thirds of total Canadian-controlled assets will still be reviewable when the new threshold on these is introduced. In effect, U.S. acquisitions of the 500 or so larger firms will continue to be reviewed.

Where Canada will change its current practice is in its policies toward firms with assets between $5 million and $150 million. Although Investment Canada has rejected no acquisitions proposals involving firms of this or any other size, in some cases it has required that U.S. interests undertake certain commitments before being allowed to proceed with their acquisition. Under the Agreement, this will no longer be possible. Many of the firms in this size sector have experienced exceptionally rapid growth in recent years.

Except for those on foreign trade and stock equity, existing benefit criteria will continue to apply under the Agreement to larger acquisitions. These criteria include the effects on competi-

tion and international competitiveness, the employment of nationals, a range of research and productivity issues, and conformity with federal and provincial laws. Canada had already stopped setting import requirements as a condition of investment in response to a ruling by the General Agreement on Tariffs and Trade in 1983. It is doubtful that export requirements would survive a challenge under Section 301 of the current U.S. Trade Act, which is directed against such performance requirements imposed on foreign investors. Presumably, however, Canada can continue to negotiate product mandates, R&D, and technology transfer commitments with larger firms, even though these can have an effect on trade flows later.

U.S. Policy Changes

The United States, in turn, has given up the right to include Canadian multinationals in any review process it may introduce in the future. In the late 1970s, some members of Congress voiced strong demands for such a review process, partly in response to acquisitions of U.S. firms by investors in Middle Eastern oil-exporting countries. An interdepartmental committee was established to advise the U.S. government on policies toward inward direct investment and on sensitive cases, but its activities have stopped well short of being those of a review agency, as such. Now, however, there is pressure from some quarters to revive the idea of a U.S. foreign investment review agency, in response to the recent growth in acquisitions of U.S. firms by foreign companies.[5]

During the negotiations on the Agreement, the U.S. government attempted to free direct investment flows and the limitations on existing subsidiaries substantially, as well as to constrain future government restrictions. This effort met with some success. One way to look at the Agreement, however, is that it allows Canada to continue to review larger acquisitions by U.S.-controlled firms, while guaranteeing Canadian multinationals both greater export access to the United States and, except in specified sectors, full security to invest and to operate there. Export access and investment access are largely complementary functions, as is underlined in the next section.

Worldwide Trends

It is well to add that Canada's liberal position toward inward direct investment in the past four or five years is part of a worldwide trend. That trend reflects a variety of pressures and opportunities, such as the economic adjustments posed by growing internationalization -- a process in which multinationals often play a major role. In addition, Canada has had other reasons for moving from a policy of negotiating commitments from multinationals to one of providing a more attractive setting for them, whether they are foreign- or domestically owned multinationals.

One reason is that, since 1970, foreign control of Canadian industry has fallen steadily from about 36 percent to about 26 percent.[6] Another reason is that multinationals have concentrated their investments in fewer markets during the past decade or so, with the United States as the major recipient. International competition for such investments has increased correspondingly. A third reason is that Canadian-owned multinationals have quickly come of age. One measure of this is the accumulated stock of investment abroad by Canadian multinationals, expressed as a percentage of such investment in Canada by foreign multinationals. That ratio has risen from 20 percent in 1974 to at least 60 percent today, and is increasing rapidly.

Canadian governments have often expressed concerns about direct investment that are common among host or recipient countries. Given the changes in international investment that are taking place, however, Canadian authorities have also come to view investment from the perspec-

tive of an important home country for multinationals. In particular, Canada now recognizes the need for a more stable and less restrictive investment environment for such firms, which the Agreement will ensure. Another of Canada's concerns is the degree to which Canadian multinationals are now investing in the United States, at least in part to avoid actual or threatened U.S. protectionist measures. Home countries usually prefer, whenever possible, that their firms export, rather than invest, abroad. What the Agreement does, in effect, is to reduce the incentive for protection-induced direct investment in the United States, while guaranteeing a more stable investment climate for other and -- as will be shown below -- more important types of direct investment.

What Canada has given up, therefore, is limited in terms of current policy practices toward inward direct investment. U.S. acquisitions of smaller Canadian firms will not be reviewable. Canada explicitly retains the power to review acquisitions of larger Canadian firms and to maintain current policies that favor Canadian ownership in particular industries -- with the major exception of financial services. At the same time, Canada has gained more assured access to the United States for its own multinationals, except in those sectors where the United States already restricts foreign ownership.

The Effect on Future Policies

How one assesses the significance of the investment policy changes to which Canada has agreed depends on what has been secured from the United States through the Agreement. It also depends on which of these policies could have been sustained and what one thinks of their value in the first place.

On the first point, for example, one can note that Canada is giving up the power to use import duty waivers to attract foreign direct investment into the automobile industry, but also that this practice was likely to have been subjected to a countervailing duty test in the United States before long.[7]

On the second point -- the value of such policies -- those who believe they were wrong in their assumptions about the effects of multinationals, or that the policies were counterproductive in practice, will not regret that history cannot be repeated in quite these ways.[8] Whatever one thinks of the particular measures used in the past, however, the fact is that there are some valid concerns about multinationals, both domestic and foreign. If past experience is any guide, these concerns and a large variety of more dubious claims will become politically irresistible at fuller employment and when resource profits soar. What happens then? What happens if new and unpredictable developments raise strong calls for intervention? Keep in mind that while Canada has made only limited concessions in terms of current practice, it has agreed to some potentially significant changes in policies.

In such circumstances, the Agreement requires that the two countries deal with the issues in ways that do not discriminate by nationality of ownership. While many Canadians believe otherwise, there is strong evidence that the economic performance of foreign-owned firms is generally not inferior to that of domestically owned firms, once other determining variables are taken into account.[9] The Agreement should encourage governments to consider the underlying sources of the problems, rather than to concentrate on foreign-owned firms as has often happened in the past. Where remedies are necessary, moreover, the Agreement binds the two countries to apply them to all firms that qualify, whether owned in Canada or the United States, whether multinational or not. The discipline this imposes could be salutary, or at least no worse than what happens now.

More specifically, Canada retains quite formidable powers to intervene with

regard to investment. Here is a partial list:

1. Canada retains the power to review larger acquisitions on a reduced set of criteria. Presumably, Canada can operate the review mechanism in low gear, as at present, or tighten up its application in future if it wishes. That is a pattern one observes even in the European Community (EC), for example -- although, because it is a common market, the EC has more limitations on discrimination against EC investors than those proposed in the Canada-U.S. Agreement.[10]

2. In its 1986 Competition Act, Canada has what may turn out to be an effective set of civil law proceedings to deal with mergers and monopolies -- now called abuse of dominant position -- that substantially lessen competition. There are many interesting linkages between competition policy and investment review policy, of which only three will be noted.

First, an effective competition policy on mergers and monopolies removes an argument that was made for investment review. Mergers or acquisitions involving foreign-controlled firms may work against Canada's interests if they involve oligopolistic or monopolistic firms which reduce competition. Countries such as the United States, the United Kingdom, and West Germany, all of which lack investment review agencies, have used their power to review mergers or monopolies to discipline some types of international mergers.[11]

Second, the Agreement is likely to increase not only new investment but also mergers, acquisitions, joint ventures, and other forms of business activity, both domestic and foreign, as firms attempt to specialize production for export and to penetrate one another's markets in other ways. While studies indicate that the overall economic effects are favorable, the competitive effects in any particular industry are difficult to predict.

Third, the freer trade that the Agreement will bring will lead to increased international competition in a considerable number of industries, thereby limiting any tendency to anticompetitive behavior on the part of both domestic and multinational firms. The increased capacity to deal with mergers and acquisitions that resulted from the 1986 revisions to the Competition Act has come none too soon, but its application will have to take account of the changes the Agreement will bring in terms of a larger and generally more competitive market setting.

3. Despite national treatment, each country can treat investors from the other differently to the extent necessary for prudential, fiduciary, health and safety, or consumer protection reasons. Such different treatment must be equivalent in effect to the treatment given its own investors (Article 1602:8).

4. Canada retains the power to use a wide variety of across-the-board fiscal policies that will have a substantial impact on investment, so long as these policies do not discriminate by nationality of ownership. One of the criteria used by the review agencies, for example, was to stimulate net exports. Some of the current tax reform proposals have the same effect, but without discriminating between firms by country of ownership. Indeed, within the investment chapter, the two countries reserve the right to apply new taxes and subsidies that do not involve "arbitrary or unjustifiable discrimination" by nationality of investor. While hedged by the dispute settlement mechanism, this appears to allow more leeway than do across-the-board measures.

5. Canada more or less retains its present powers to engage in a wide range of industrial policies, subject only to the investment and trade provisions of the Agreement. Of course, if such policies are trade distorting, they will be subject to U.S. trade law. But they are subject to such law now. Only a strong code on subsidies binding both parties would have changed this, and the Agreement contains no such code -- at least not yet.

Effects on New and Existing Direct Investments

In recent years, the federal government has gone to considerable lengths to persuade multinationals that Canada warmly welcomes their investments. Competition for such foreign direct investment has become commonplace among governments desperately attempting to increase jobs, tax revenues, and technical capacities. Increasingly, however, one hears the concern that the Agreement will doom such efforts to attract investment. Indeed, some argue that the reduction or elimination of Canadian protection could encourage many manufacturing firms to withdraw from Canada. That was the central point, for example, in a report prepared for the Ontario government in connection with the Halifax meeting of federal and provincial government leaders.[12] It is a point of considerable interest in view of the fact that Canada's share of inflows of direct investment to 13 developed market economies fell from 16 percent in the mid-1970s to 3 percent in the late 1970s, and was negative in the early 1980s. Canada's contribution to outflows rose from 2 percent to 9 percent over this period.[13]

At the outset it should be noted that, although many economic variables and policies can affect investment by multinational firms, what is of interest here is the response of such firms to the Agreement. One needs to consider new investments and acquisitions abroad, and the ongoing activities of existing subsidiaries in each country. At least three types of multinationals should be considered: U.S. multinationals with subsidiaries in Canada, Canadian multinationals with subsidiaries in the United States, and third-country multinationals with subsidiaries either in Canada or the United States. The analysis presented here focuses largely on manufacturing, rather than on primary products, since concerns about divestment center on the former.

Finally, it should be emphasized that the objective of a free trade agreement is better defined as to increase economic efficiency and real incomes through a larger and more secure market, rather than to promote foreign direct investment as such.[14] This study concentrates largely on the latter because of the view that major divestment and consequent dislocation is likely to occur with free trade.

U.S. Investment and the Canadian Manufacturing Sector

Canada has long relied on tariffs and other barriers to imports to persuade domestic and foreign-owned firms to manufacture here. In the face of an Agreement that will eliminate tariffs and limit the extent to which governments can use other barriers to imports and similar inducements to invest here, why should these firms do so? Indeed, why should there not be a gradual exodus of a considerable number of existing foreign-owned subsidiaries, particularly those which have benefited from such policies?

There is no doubt that the Agreement will cause some existing subsidiaries to close down, as will some Canadian-owned plants. Other firms that might have established here because of tariffs will not do so. But these divestments are not likely to be nearly as large or as worrying as some have suggested. The results are not all bad for Canadians, and offsetting increases in investment are likely to exceed decreases by a considerable margin. There are at least three major reasons for doubting the pessimistic predictions.

New Investment Decisions

First, there is the considerable evidence on how multinationals decide to enter new markets. That evidence clearly suggests that while tariffs and other forms of protection have played a role in attracting direct investment into manufacturing, other variables are usually more important, for two reasons. One is

that multinationals must decide which form of organization to use in serving foreign markets -- that is, whether to trade, to license, or to enter into a joint venture with independent parties, or to do all these things through controlled subsidiaries. Multinationals favor such subsidiaries in many types of activities or markets where they increase profits -- for example, by slowing the loss of information to competitors or by making it easier to transfer technology -- quite apart from whether protection exists.[15]

The other reason is that the decision to locate in a particular market is influenced by more than just the degree of protection. Location decisions are also based on:

- the size and growth of markets;
- the costs of production and distribution;
- the nature of the competition involved; and
- government attitudes to business as expressed in a variety of fiscal and regulatory policies, including protection.

The evidence indicates not only that tariffs and nontariff barriers can affect the location of some types of investment, but also that the other variables matter more in the typical case.[16] It should also be noted that, for many existing subsidiaries, tariffs played a larger role when such firms were established in Canada, often many decades ago, than is the case today.

The Behavior of Existing Foreign-Owned Firms

The second reason for doubting pessimistic predictions about the Agreement's outcome concerns the fate of the large number of existing subsidiaries in Canada under a free trade regime. It is well known that many of these have unit costs in excess of plants in the United States. There is concern, therefore, that the parent firm's strategy would dictate closure or reduction of the activities of some subsidiaries -- specifically, those sometimes referred to as "tariff factories". What needs to be kept in mind is that the Agreement changes all four of the major investment determinants, and it does so in ways that are largely favorable to Canada. Expanded and more assured access to the U.S. market, combined with the spur of increased import competition, will give substantial incentives to manufacturers to drop some lines and to specialize more fully in others. More efficient scale and lower unit costs will be the typical outcome.

Almost all of the major published studies of what will happen in Canada under freer trade are favorable in this respect.[17] These studies generally conclude that Canada will be a competitive source for a wide range of manufactures. The effects on national income and investment, and on overall employment in manufacturing, are all expected to be positive.

The studies also note that there will be significant adjustment costs for labor in some industries in the transition period while specialization is being developed. Contrary to an impression left by a number of persons on both sides of the free trade debate, there are several studies that indicate the industries where the declines are likely to be concentrated.[18] Provided that the changes occur slowly and in ways that limit the damage to those involved, they should not be counted as a total loss -- business firms that cannot exist without a permanent tax on consumers or that require frequent subsidies from government are not the best kind from the community's long-term viewpoint.

A major reason why these studies conclude that there will be significant gains from freer trade is that the rationalization of production occurs mainly within firms and industries, rather than among them, thus minimizing the adjustments involved for labor, capital, and communities. This is evident from the

experience of other such trading arrangements. One need not go abroad for this evidence, however. During the 1970s, the pressure from falling tariffs, increasing sources of international competition, and oil price shocks forced adjustments on Canadian industry that were much larger than those to be expected from a gradually phased-in bilateral free trade arrangement. Economic Council of Canada studies show that import and export penetration increased in a wide range of manufactures in that period.[19]

In his study for the Ontario government, noted earlier, Baranson suggests that an accelerated and extensive departure of foreign-owned firms, except for oil and gas investments, can be expected because of the way technologies are changing. Computer-integrated manufacturing, he argues, will reduce the gains from economies of scale and also tend to concentrate production geographically in the parent countries.

One should keep an open mind, about conjectures regarding the nature and pace of future technological change, especially those based on a few examples rather than on a systematic analysis. So far as the free trade issue is concerned, there are several points to note. If economies of scale become less important, this should put firms in Canada at a reduced disadvantage, provided they can make the necessary investments and keep them running at capacity. Are not both of these more likely in a larger and more secure market? As for geographic clusters, Ontario, in particular, is well placed, with half of Canada's manufacturing and its close linkages to nearby clusters in the populous east and east-central U.S. states. Most important, with or without free trade, Canada is not going to escape the impact of technological changes that are adopted elsewhere. Some researchers have concluded that Canada's chances of absorbing such changes effectively are much better in a larger and more competitive market setting.[20]

Competitive Adjustments to Free Trade

Third, if one looks at the competitive process by which firms adjust to free trade, even more doubts are raised about the view that the Agreement will reduce foreign direct investment. Firms are not in a position to export to a foreign market just because government barriers to trade have been eliminated or stabilized, even if transport costs are low enough to allow trade. Established competitors in the other market will attempt to protect their market shares by a wide variety of tactics. They can try to forestall entry to their market by building extra capacity, or by investing more in R&D or product differentiation. These and other techniques signal increased barriers to entry or increased competition after entry. Both of these could scare off the potential entrant, which may decide that a less disturbing or more effective way to enter the foreign market would be through acquiring an existing firm, rather than through direct exports. Still less risky is a licensing arrangement or joint venture with a foreign firm. Of course, such tactics are also open to the foreign firm. It might decide that the best way to deal with an efficient exporter is to buy it out, or to try for a license or other arrangement.

What these different ways of reacting to a potential competitor have in common is increased foreign direct investment and technology contacts in both directions. These techniques typically also involve considerable exchanges of goods and services between the related parties. It is a mistake, in other words, to think of trade and foreign direct investment simply as substitutes for each other, as the tariff-factory argument suggests. In today's world, trade and investment are increasingly complementary. To a considerable extent, that was already the case when the European Common Market was established. As internal tariffs came down, investment from overseas and intra-European investment both grew

rapidly. It was the smaller European countries that engaged most aggressively in acquiring "fifth-column investments" designed to penetrate the larger markets of established competitors.[21] Intra-firm trade, in fact, has been a rapidly growing part of world trade in manufactures, both in finished and intermediate products, in the past few decades.[22]

Country of Ownership and the Adjustment Process

It may be objected that some of the major studies cited consider the manufacturing sector without distinguishing the country of ownership of the firm. Foreign-owned firms have the advantage of marketing, financial, and technical ties that will ease the adjustment process. Frequently, however, such firms do not have an independent strategic planning capacity, and may face resistance from foreign affiliates that are reluctant to accommodate changes in Canada if they involve adjustments such as plant closures. For Canadian-owned firms, especially the smaller ones, the problems are the reverse: more independence in planning, but fewer, if any, affiliates abroad to help with marketing and other ties.

Fortunately, several studies have paid attention to the country of ownership of the Canadian firm in their examination of the adjustment process. One of the most inclusive of these studies the responses of all manufacturing firms to the trade opportunities of the 1970s, a period of significant declines in tariff protection.[23] As noted above, both import and export penetration increased in manufactures in this period, as the specialization argument suggests. The study also finds that foreign ownership as such does not exacerbate the lack of specialization and scale that has plagued many manufacturing firms.

Another study, which examines the 21 largest Canadian-owned multinationals and the 17 largest U.S. subsidiaries in Canada, suggests that their reactions to bilateral trade liberalization will be very similar. Specifically, these firms expect to adjust readily to new trade regimes, and they regard trade and investment as largely complementary rather than as substitutes.[24] In another study, D.J. Daly and D.C. MacCharles look at a matched sample of medium-sized and smaller firms, including 15 U.S.-owned subsidiaries and 15 Canadian-owned firms in secondary manufacturing. The authors' findings do not support the idea that subsidiaries have closed down during the trade liberalization of recent years, and they argue that both sets of firms must specialize for export even more if they are to meet the competitive challenges of the future.[25]

Yet another study, covering 23 businesses or divisions of 13 firms, considers in some detail four options open to foreign-owned firms in Canada as import tariffs decline and pressures to specialize increase.[26] These options are: to continue with the present degree of product diversity; to import in place of Canadian production; to rationalize production between the Canadian and U.S. affiliates; or to rationalize production and develop world product mandates -- that is, to develop in the subsidiary the various skills needed for product renewal in international markets. Among the authors' findings are that the processes of adjustment to international competition have been under way for some time; that specialization for worldwide production is at the heart of the adjustment; that this requires incentives to develop innovation skills, including those related to export marketing, particularly in the case of world product mandates; that Canadian-owned firms face similar or greater pressures and problems; and that the foreign-owned businesses studied are more interested in converting to specialization than in divesting.

The final study of interest here is a recent one by the Economic Council of Canada. This is a sectoral study that examines the processes by which multinationals in Canada adjust to several

types of pressure, including tariff reduction.[27] Its main conclusions are:

- that multinationals are not more inclined than other firms to shift their operations to low-cost foreign sources of inputs;
- that they are not more likely than other firms to sell or close their plants, if domestic demands falls;
- that -- while there is less agreement here -- in the face of trade liberalization and growing markets, such firms have rationalized production in the same way and degree as domestic firms;
- that where industrial growth is rapid, often in R&D-intensive sectors, U.S. subsidiaries in Canada have grown relative to U.S. subsidiaries in other developed countries; and
- that while employment in Canadian subsidiaries has fallen relative to that in U.S. parent firms in many industries, this is less the case for industries in which Canadian trade barriers have been reduced the most.

Effects on other Types of Direct Investment

As far as other sectors are concerned, the Agreement is likely to lead to increased investment in Canadian natural resources by both foreign and Canadian multinationals. Most studies show that Canada already has a comparative advantage in a number of primary resource and manufacturing industries. The removal of even small barriers to exports -- or the reduced threat of such barriers -- should significantly increase investments to process such products further, wherever transport costs allow export. As for the services industries, some, such as banking, prefer or even require subsidiaries or branches rather than trade when they go abroad. The removal of barriers should increase foreign direct investment in such industries.

In the past decade or so, Canada has become an important exporter of business capital.[28] Manufacturing plays a smaller role on the outflow side, and marketing and management skills often are more important than technological advantages. Moreover, as noted earlier, there are several determinants of direct investment, and protection is usually not the most important. Nonetheless, U.S. protectionism has played a role in persuading some Canadian firms to locate in that country instead of exporting from Canada. To that extent, free trade will keep new investments here, along with the resulting jobs and tax revenues. But one should not expect free trade to lead to

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any substantial divestment of Canadian firms that are already in the United States. Instead, one should expect, based on the experience of other trading areas, much greater competition for new investment within the rules of the Agreement.[29]

Finally, what about investment in Canada or the United States from third-country firms? Many such firms hesitate to produce in Canada today for the combined Canadian-U.S. market simply because export access to the larger U.S. market could be blocked. The Agreement should reduce or even remove this concern. As noted earlier, the location decisions of multinationals depend on a variety of market, cost, competition, and policy variables. Moreover, the Agreement does not eliminate U.S. protectionism but merely reduces it. It would be surprising, however, if those who promote investment in Canada do not argue the obvious when dealing with third-country investors. New Zealand, for example, has been letting the world know that what was once a potential market of less than 4 million persons is now, under its trade agreement with Australia, moving to a potential market of 20 million. For Canada, the change would be proportionately greater.

Conclusions

Fears of a major exodus of foreign-owned firms and capital from Canada in response to a bilateral free trade agreement with the United States are much exaggerated. Some divestment will occur in some firms and industries, but the offsets in manufacturing are substantial. They include rationalization by U.S. firms already engaged in secondary manufacturing in Canada so as to take advantage of the large and more secure U.S. market; gearing up by Canadian-owned secondary manufacturing firms for the same purpose; expanded investment in primary resource processing; and expanded third-country investment in the new, enlarged Canadian-U.S. market. It is highly unlikely that all of this will lead to net divestment. The investment that remains, moreover, will not levy a permanent tax on consumers in the way that tariff-induced investments often do. Finally, once one takes account of the reactions by firms to market entry, direct investment may well increase both ways for a time.

It should be added that the tests, both retrospective and prospective, of what happens to manufacturing industry with freer trade are, in the main, better than those of changes in the direct investment sector.[30] What happens, accordingly, if the analysis above should prove to be wrong and there is a massive divestment of capital from Canada because of free trade?

Several adjustments would occur to limit the damage.[31] The value of the Canadian dollar would fall, increasing the cost of transferring funds out of Canada and making Canada a better location for export. No doubt, some sources in the United States would be unhappy with this development. Given its origin, however, they could hardly argue that it reflected an attempt by the Canadian government to depreciate the exchange rate. Moreover, such a fire sale of foreign-owned assets would mean low prices for them. This, in turn, would tempt other investors to try to operate the assets, perhaps in conjunction with a technology or marketing license negotiated with the former owners. Such sales have often occurred in recent years as foreign and Canadian multinationals have restructured their domestic and foreign operations.

In contrast to this pessimistic scenario, there is the possibility of <u>increased</u> direct investment in the Agreement's transition period. This could lead to an increase in the degree of foreign ownership of Canadian industry for a time, although this would depend on the Agreement's effect on investment in Canada more generally.

In the longer term, two developments should be set against any tendency for

the share of foreign ownership to rise. First, Canadian-owned firms with just one plant or only a few plants would be less likely to merge with multinationals, since they can achieve efficient scale and related headquarters functions independently in the enlarged market. Second, with increased efficiency, the capital-to-output ratio would fall in some sectors, thus reducing reliance on foreign capital to finance investment. While direct investment is not closely associated with capital scarcity, to the extent that capital and technical change go together this could also lessen the degree of foreign ownership.[32] Both of these points are likely to be less important than the fact that, for a variety of international and domestic reasons, Canada's share of world direct investment has fallen sharply over time, as has the degree of foreign ownership of Canadian industry since about 1970.

In summary, Canadian governments retain quite extensive powers to influence investment, and substantial divestment is unlikely. Two caveats should be added, however, to put this discussion of direct investment in context.

First, the capacity to attract new investment -- to revitalize old industries and capture new ones -- depends on a range of market, cost, and government policy variables that go beyond the scope of this Trade Monitor. A free trade environment is only one, albeit important, aspect of a policy designed to assure a more competitive industry and more secure access to Canada's largest foreign market. It will not succeed by itself in attracting new investment over time if other policy variables are damaging.

Second, while the evidence suggests the adjustments will not be severe, some sectors and workers will be under considerable competitive pressure for a time. One of the more important tests of the economic desirability and political feasibility of free trade is precisely whether convincing arrangements exist to assist people in coping with the changes that will come with it, changes that involve costs as well as benefits.

Notes

1. The first section of this Trade Monitor is based on A.E. Safarian, "Investment Aspects of the Canada-U.S. Free Trade Agreement," in M.G. Smith and F. Stone, eds., Assessing the Canada-United States Free Trade Agreement (Halifax, N.S.: Institute for Research on Public Policy, 1987). The second section draws in part on idem, "The Relationship between Trade Agreements and International Direct Investment," in D.W. Conklin and T.J. Courchene, eds., Canadian Trade at a Crossroads: Options for New International Agreements (Toronto: Ontario Economic Council, 1985).

2. The term "free trade" is used throughout because of the title of the Agreement. What will be achieved, if it is approved, is, of course, freer trade. By foreign direct investment, we mean those flows of capital, and the retention of earnings, that increase nonresident control of industry. Such flows are to be distinguished from portfolio investment, such as sales of government bonds abroad.

3. These provisions are contained in the following chapters of the Agreement: Chapter 14, Services; Chapter 16, Investment; Chapter 17, Financial Services; and Chapter 20, Other Provisions (Article 2005, Cultural Industries).

4. For a more complete list, see Organisation for Economic Co-operation and Development, National Treatment for Foreign-Controlled Enterprises (Paris, 1985).

5. Ohio, for example, has passed legislation allowing it to assess the economic effects of foreign takeovers. This legislation, the constitutionality of which is in dispute, is aimed directly at an attempt by a Canadian company to acquire a firm with substantial operations in Ohio. See "Campeau tells rival for Federated to back off," Globe and Mail (Toronto), February 13, 1988, p. B7.

6. Statistics Canada, Canada's International Investment Position, Cat. no. 67-202, 1968-70 and subsequent issues. By another measure, the degree of foreign ownership of equity in corporations that are 50 percent or more foreign-owned fell from 37 percent in 1971 to 24 percent in 1985 (see Statistics Canada, Annual Report of the Minister of Supply and Services Canada under the Corporations and

Labour Unions Returns Act, Part 1, Corporations [Ottawa, 1985]).

7. P. Wonnacott argues this point in U.S. and Canadian Auto Policies in a Changing World Environment, CAC 56 (Washington, D.C.; Toronto: Canadian-American Committee, 1987).

8. For a more complete explanation of my reasons for evaluating Canada's major foreign investment policies negatively, on balance, see A.E. Safarian, "Government Control of Foreign Business Investment," in J. Whalley, ed., Domestic Policies in the International Economic Environment (Toronto: University of Toronto Press, 1985).

9. See Ibid. for a review of this evidence. A specific example of this misplaced emphasis is one critic's claim that the Agreement will result in a major loss of jobs. This claim is based on a detailed report by Statistics Canada on employment changes over time, including those in foreign-owned and domestically owned firms. As the Chief Statistician for Canada points out, however, the report actually demonstrates that, once allowance is made for the concentration of foreign-owned firms among the larger firms and in the goods-producing sector, the job creation record of the foreignowned firms is very similar to that of the domestically owned firms. See J.L. Orr, "Signing the deal means backing the wrong horse," Globe and Mail (Toronto), December 17, 1987, p. A7; and reply by I.P. Fellegi, "Statistics don't say it all," Globe and Mail (Toronto), January 20, 1988, p. A7.

10. For a survey of investment policies in the EC, see A.E. Safarian, Governments and Multinationals: Policies in the Developed Countries, BNAC 33 (Washington, D.C.: BritishNorth American Committee, 1983).

11. G.L. Reuber and T.A. Wilson argued a decade ago that the Foreign Investment Review Act should be rescinded and any elements considered essential should be integrated with a revised Competition Act. See their article, "Merger Policy Proposals: An Evaluation," in J.R.S. Pritchard et al., eds., Canadian Competition Policy (Toronto: Butterworths, 1979), especially pp. 260-262.

12. J. Baranson, Assessment of the Likely Impact of a U.S.-Canadian Free Trade Agreement upon the Behaviour of U.S. Industrial Subsidiaries in Canada (Toronto: Ministry of Industry, Trade and Technology, September, 1985).

13. Safarian, "Government Control of Foreign Business Investments," p. 10. See also OECD, Recent Trends in International Direct Investment (Paris, 1987).

14. This point has been made in an excellent short theoretical analysis by D.F. Burgess of the effects of free trade on direct investment. His analysis suggests that Canada is likely to import more direct investment, but he cautions that this is a tentative conclusion. See "The Impact of Trade Liberalization on Foreign Direct Investment Flows," in J. Whalley, ed., Canada-United States Free Trade (Toronto: University of Toronto Press, 1985).

15. The literature on the choice between the use of a subsidiary, trade, and a mixed formed of organization is summarized in R.E. Caves, Multinational Enterprise and Economic Analysis (Cambridge: Cambridge University Press, 1982), especially Ch. 1-2; and A.M. Rugman, Inside the Multinationals: The Economics of Internal Markets (New York: Columbia University Press, 1981).

16. The many empirical studies involved cover decisions by multinational firms based in a variety of countries, including Canada and the United States. For a discussion of the factors that influence the location of investment by U.S. multinationals, see OECD, Investment Incentives and Disincentives and the International Investment Process (Paris, 1983). A.M. Rugman presents the results of four studies of Canadian direct investment in the United States, only one of which may give protection a significant weight in the investment decision (see Outward Bound: Canadian Direct Investment in the United States, CAC 54 [Toronto; Washington, D.C.: Canadian-American Committee, 1987], Ch. 2-3). R. Caves gives the case for tariffs as a determinant of direct investment in Multinational Enterprise and Economic Analysis, pp. 40-43.

17. There is a long list of such studies, many of which are summarized in J. Whalley, Canada-United States Free Trade (Toronto: University of Toronto Press for the Royal Commission on the Economic Union and Development Prospects for Canada, 1985), especially Ch. 1. Two of the more comprehensive studies are R. Harris with D. Cox, Trade, Industrial Policy and Canadian Manufacturing (Toronto: Ontario Economic Council, 1983), and S. Magun, et al., Impact of Canada-U.S. Free Trade on the Canadian Economy, Discussion Paper no. 331 (Ottawa: Economic Council of Canada, 1987).

    A subsequent study of the actual terms of the Agreement also concludes that it would increase output, employment, and real incomes in Canada, while also underlining that the size of the gains would depend on the extent to which the productivity of the Canadian manufacturing sector can be increased by other competitiveness-related policies. See S. Magun et al., Open Borders: An Assessment of the Canada-U.S. Free Trade Agreement, Discussion Paper no. 344 (Ottawa: Economic Council of Canada, 1988).

18. Employment gains and losses by industry are estimated, for example, in Economic Council of Canada, Reaching Outward, 27th Annual Review (Ottawa, 1987), Ch. 3.

19. Economic Council of Canada, The Bottom Line: Technology, Trade and Income Growth (Ottawa, 1983), especially Part C. See also A. Baldwin and P. Gorecki, Trade, Tariffs, Product Diversity and Length of Production Run in Canadian Industries, 1970-79, Discussion Paper no. 247 (Ottawa: Economic Council of Canada, 1983).

20. Several studies by D.J. Daly emphasize this conclusion. See, for example, "Cost Competitiveness in Canadian Manufacturing: The Challenge and Some Policy Options" (York University, Toronto, 1984, Mimeographed).

21. Other factors, such as nontariff barriers, were also at work. See L.F. Franko, "European Multinationals in the Integration Process," in G. and V. Curzon, eds., The Multinational Enterprise in a Hostile World (London: Macmillan Press, 1977).

22. Particularly interesting in this regard are empirical tests showing exports and foreign production expanding together in U.S. manufacturing firms. See R.E. Lipsey and M.Y. Weiss, "Foreign Production and Exports of Individual Firms," Review of Economics and Statistics 66 (1984): 304-308; and idem, "Foreign Production and Exports in Manufacturing Industries," Review of Economics and Statistics 63 (1981): 488-494. For a detailed study of intrafirm trade by multinationals in Canada, see D.C. MacCharles, Trade among Multinationals: Intra Industry Trade and National Competitiveness (London: Croom Helm, 1987).

23. Baldwin and Gorecki, Trade, Tariffs, Product Diversity, pp. 54-65, 109-116. One might add that Canadian-owned firms moved further toward specialization in the 1970s, perhaps in part because they were less specialized earlier. MacCharles also supports this conclusion (see Trade among Multinationals, Ch. 5).

24. A.M. Rugman, "Living with Free Trade: How Multinationals will Adjust to Trade Liberalization," Business Quarterly 52 (Fall 1987): 85-90. See also idem, Trade Liberalization and International Investment (Ottawa: Economic Council of Canada, forthcoming).

25. D.J. Daly and D.C. MacCharles, Canadian Manufactured Exports: Constraints and Opportunities (Montreal: Institute for Research on Public Policy, 1986), especially pp. xix, 77.

26. P.M. Bishop and H. Crookell, "Specialization and Foreign Investment in Canada," in D.G. McFetridge, ed., Canadian Industry in Transition (Toronto: University of Toronto Press, 1986).

27. Economic Council of Canada, Managing Adjustment: Policies for Trade-Sensitive Industries (Ottawa: Supply and Services Canada, 1988) pp. 14-18. This publication contains a summary of the study, which has not yet been published.

28. For evidence on how free trade may affect outward direct investment, see Rugman, Outward Bound; idem, "Living with Free Trade"; and idem, Trade Liberalization and International Investment.

29. See, for example, S.E. Guisinger and Associates, Investment Incentives and Performance Requirements (New York: Praeger, 1985), Ch. 1.

30. B.M. Wolf makes this case in "The Reaction of U.S.-Based Multinational Enterprises to Free Trade between Canada and the United States: Impediments to Empirical Verification" (Paper presented in Montreal to the North American Economics and Finance Congress, York University, Toronto, 1986, Mimeographed).

31. For further analysis of this point, see Burgess, "The Impact of Trade Liberalization."

32. For an analysis of these points, see H.C. Eastman and S. Stykolt, The Tariff and Competition in Canada (Toronto: Macmillan of Canada, 1967), Ch. 4; and R. Wonnacott, Canada's Trade Options (Ottawa: Economic Council of Canada, 1975), pp. 101-103.

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